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THE SECURITIES MARKET AS AN INDEX OF BUSINESS CONDITIONS

By Thomas Gibson,
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That present business conditions are excellent, does not admit of argument. We may easily measure the extent of activity by such barometers as bank clearings, conditions in the iron and steel trade, railroad earnings and the crops. The recovery from severe depression has been unprecedented in its rapidity, and so far as can now be seen, there are very few clouds on the horizon.

It is, however, always the case after a rehabilitation of this character, that we are prone to grow a little too enthusiastic; to over-estimate possibilities and to allow our optimism to carry us somewhat further than is warranted. Optimism is a good thing. The man who has learned to believe things has learned a great deal; but the man who learns to believe too much is in danger. When a remarkable and rapid convalescence has taken place in the business world it does not follow that no disappointments will come. As a Persian proverb has it, "No tree ever grows to heaven." Both security prices and general business have now reached, or at least are nearing, a stage where caution should be exercised and where academic examinations are more important than plain information. A year or two ago we could argue with a great degree of confidence that in the natural order of things, improvement would occur. We were right; the anticipated improvement is now before us and being a demonstrated fact, ceases to be speculative.

As an example of the tendency to ignore whatever may be evil during a period of confidence and prosperity, it may be noted that we have encountered some disappointments recently in our crop prospects; notably in corn and cotton. Such disappointments are either dismissed by the bold statement that the government estimates are entirely wrong, or by specious statements which will not bear the light of logic. After the last government report showing a reduction of almost 300,000,000 bushels in our corn crop estimates, the arguments were heard on every hand that even

with the reduction we would make a good crop of corn, and that high prices made up for any deficiency which might occur in the supply. Admitting the truth of the statement that a fair crop was indicated, even after subtracting the loss, it must be remembered that many business plans had been made in anticipation of a much greater crop. The fallacy of assuming that high prices can cover deficiency of supply can be exposed by the most elementary study of economics. This is particularly true of a commodity like corn, which is practically all consumed within our own borders. A bountiful crop, at reasonable prices, gives employment to laborers and railroads, and permits the consumer to provide for his wants at a fair figure. A poor crop at high prices cuts down the general purchasing power of farming commitments; decreases railroad traffic, both freight and passenger, and amounts in the last analysis to the mere swapping of dollars. With cotton it is somewhat different, as cotton is our great money crop, and the money received from that commodity is greater than the sum received from our exports of all cereals combined; even when we include these cereals in their manufactured form, such as flour, meats, glucose, etc. Our short cotton crop is, therefore, to some extent, offset by higher prices, but the loss of traffic to carriers, and the improper distribution of money remains. In my opinion the ideal form of prosperity is represented by normal production and normal prices throughout the civilized world.

In prognosticating security prices, we go much further into the future than in examining general business prospects. The anteriority of stock prices is the most important of all factors which are presented to the student of prices or values. The market not only discounts all that is *known*, but the brightest minds in the world are constantly engaged in analyzing what is *probable*. For example, the stock market made no advance in 1906 and declined steadily during the greater part of 1907, yet both these years were years of big business. The depression of 1908 was discounted, and when 1908 arrived, a year of stagnation, security prices moved steadily upward. From January 1 to December 31, 1908, the average level of railroad stock prices advanced about twenty-nine points. Since January 1, 1909, they have advanced to this writing (September 25) about ten points, and in the last two months, during which our anticipated improvement in business has taken

visible form, they have advanced not at all. This is shown by the following table:

AVERAGE PRICE OF RAILROAD AND INDUSTRIAL SECURITIES SINCE PANIC OF 1907.

	Lowest in panic (Nov. 21, 1907).	Jan. 2, 1908.	Dec. 31, 1908.	Aug. 1, 1909.	Sept. 25, 1909.
Railroads	65.61	71.75	99.97	110.55	109.52
Industrials	46.87	49.69	75.29	83.69	83.88
General average	56.24	60.72	87.63	97.12	96.70

On January 2, 1907, the same securities averaged 105.27 for railroads and 86.41 for industrials. Therefore, the panic of 1907 has been wiped out so far as security prices are concerned.

It is my opinion that the recovery in business both as it refers to actual developments and to such prospective probabilities as are plainly in evidence has been discounted in security prices. This does not mean that prices are too high, but that they are, generally speaking, high enough so far as our recuperation may be measured. What we must now seek in order to gauge future movements intelligently, are the submerged factors. The man who can correctly foresee the business affairs of 1910 and 1911 is the man who will make money in securities now. What we already know is of no further value. To attempt to *speculate* on known factors is a direct contradiction of the word "speculation."

Looking at values, instead of prices, we find few rules for our guidance. Even stability of dividend or interest rates does not guarantee us against violent price changes. In the panic of 1907 Chicago and Northwestern, a seasoned investment stock, made a greater percentage of decline than did Union Pacific, a highly speculative security, with an untried rate of disbursement. We may try to adopt the rate of income on high-grade securities with a long dividend record as a guide, only to find that any rule we may formulate is empirical. In 1881 the market collapsed from an average yield of five and one-quarter per cent. In 1891 prices advanced until the yield on the same securities was reduced to four and one-half per cent, and in the boom of 1906 the high stock prices cut the yield down to three and one-quarter per cent. At present the average is about four per cent. If we equal the record of 1906 our stocks would have to advance ten to fifteen points, on the average, from the present prices. But in looking at the possi-

bility of such an advance, we must remember that early in 1906 stock prices overleaped themselves very badly, and that the pinnacle was of an artificial and temporary nature. Personally I should say that four per cent is a small enough yield and that further advances should be based more upon dividend increases than upon present conditions. It will not do to lend a too credulous ear to the inspired talk or street rumors of forthcoming dividend increases or other emoluments. The only way to arrive with any degree of accuracy at a probable increase of distributions is to scrutinize the published reports of the corporation in question and see if such an increase is warranted. Such study will sometimes develop the fact that a dividend is increased without any justification, in which case we may be certain that the stock is a trap and that the increase is for the edification of the public, in order to induce careless and unsophisticated people to buy. There is always some talk of "concealed assets" when a corporation advances dividends without a reason for so doing, but it is a good plan to avoid properties which resort to concealment of anything.

One thing to which the student of security values should give earnest consideration at present is the comparative values of railroad and industrial securities. Industrial issues may be said to be in their infancy, but many of them have excellent dividend records particularly in relation to the preferences. The business and earnings of industrial corporations are more flexible than is the case in railroads, but the gradual enhancement of value is more rapid. The growth of the United States Steel Corporation is an instance of what a well-managed industrial enterprise can do. Fundamentals are also in favor of industrial stocks. The steady advancing trend of commodity prices operates against railroad issues and in favor of many industrial issues. Bonds and securities, with a fixed rate of income, are also unfavorably affected by this continued rise in commodity prices. The basic cause of this tendency has been assiduously sought by students for some years, and the consensus of opinion favors the gold theory. Personally I have accepted the theory as being correct, and also as being the most vital fundamental affecting the different classes of securities.

I cannot undertake, in the space assigned to me, to enter into a full discussion of this large phase of the question, but a few suggestions may be of interest. The increasing supply of gold

tends to advance commodity values. The index numbers of Dun's, Bradstreet's, and other compilers, show that in ten years commodities generally have advanced almost fifty per cent. Gold, being a fixed standard, cannot apparently decline, but the oversupply is represented by a loss in purchasing power, *i. e.*, an advance in the things gold will buy.

This advancing trend of commodity prices tends to increase interest rates or, rather it tends to add amortization to interest. The man who loaned ten thousand dollars ten years ago at five per cent has the principal returned to him to-day with its purchasing power reduced almost thirty-three and one-third per cent. Therefore he has had very little, if any, interest on his loan, as money can be measured only by what it can buy. If these two influences are admitted, we may adduce the following effects on security prices:

(1) Bearish on bonds, preferred stocks, or other securities having a fixed rate of interest.

(2) Bearish on the common stock of railroad corporations. The cost of maintenance, equipment, rails, and all other commodities, including labor, goes up steadily, while traffic rates rise grudgingly. The evil effects are offset, to some extent, by returns in the form of dividends, enhancement of property values, etc., but these emoluments do not entirely overcome the higher cost of operation.

(3) Bullish on the securities of industrial corporations. Here the selling price of the commodity produced rises with the cost of production. Exceptions should be noted in the case of gas, electric lighting and other public utilities corporations where the selling prices are fixed by law.

(4) Bearish on securities of traction corporations. This is probably the weakest spot of all. The five cent fare is proverbial and will be advanced with great difficulty to meet the increased cost of producing transportation.

(5) Bullish on the prices of speculative commodities, such as wheat, corn, cotton, etc. We need only glance at the nominal prices of these commodities a decade ago, as compared with to-day, to see how steadily the level has risen.

It is a great mistake to argue that the effects of increasing gold production are too remote, or too slow of operation, to affect the investor or speculator. The matter should receive the serious atten-

tion of every man who is interested in, or contemplates being interested in, securities or business of any kind. The literature on the subject is rather meager, but there are several good works which cover the main question thoroughly.

In examining the numerous influences which affect security prices and values from year to year, we may count the salient factors on the fingers of one hand. Crops, gold production, money, mining and politics. There are many interdependent factors, of course. In fact, so far as the movements of security prices are concerned, everything appears to hinge on the crops. It is found that only once in twenty-five years has the stock market failed to advance in good crop years, or to decline in poor crop years. The exception occurred in 1896. That year was a cardinal exception, as the silver agitation had tentatively discredited us, in the eyes of the entire financial world. Bank clearings, trade balances, etc., which have been mentioned as being barometrical, depend primarily upon the crops. With large cereal, cotton, fruit and hay production, we will have satisfactory bank clearings and satisfactory trade balances. Mining is not subject to the climatic influences bearing on the crops and can be more accurately gauged.

It has been my intention in this article to emphasize the necessity of continually studying future probabilities in forming our opinions as to the future of security values. In this I have probably digressed from the subject as laid down for me by the editors of this work. Reverting to the exact title, "The securities market as an index of business conditions," I will offer the brief opinion that business improvement is about discounted in the rank and file of securities. For bonds I see little hope of an advance from this level and some strong possibilities of a sagging tendency in the not distant future. The preferred stocks of railroads are also high enough. There are still some bargains in the industrial preferences but they are few in number. Railroad common stocks which pay dividends are on a four per cent income basis, which is high enough under present money conditions. Further advances in this group are dependent on the ability of corporations to increase dividends or show a greater net earning power. Industrial common stocks are in the speculative class as yet, but the investor who is capable of discrimination, will probably find his greatest opportunities in this group.